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Report of the Real Property Tax Advisory Commission 2014

1 BACKGROUND

Under Resolution 11-143, FD1, the Honolulu City Council established a Real Property Tax Advisory Commission consisting of seven citizens. Our charge was to conduct an objective review of the City & County of Honolulu real property tax system.

We understood and appreciated that our commission was not the first, and we in fact had a member on our commission who also served on the previous commission that rendered its report in January 2012. We gratefully acknowledge the efforts of our predecessors, and to an extent we are picking up where they left off. For example, the prior report adopted six principles of good tax policy, and we found no need to revisit or reexamine them. We did note that we face some significant issues that did not exist in 2011 when our predecessors performed most of their work. In addition, we did feel the need to revisit one or two issues that our predecessors touched on.

The role of our commission is purely advisory. Our recommendations are sent to the Council for them to act as they see fit consistently with their roles and responsibility to their constituents. Most, if not all, of the recommendations contained in this report can only be implemented by amending the Revised Ordinances of Honolulu, which can only be done using a process that requires exposure of the concepts to the public and a consequent opportunity for the public to submit testimony and comments.

Despite the protections and safeguards already built into that process, our commission heard testimony that the Residential A property classification adopted in 2013, which is discussed in much more detail below, caught more than a few homeowners unaware – they did not fully appreciate the consequences of this classification until they received their real property tax billings, and at that time it was already well past the deadline fixed by ordinance either to appeal the classification or to apply for a homeowner's exemption, which if granted would drop the parcel out of Residential A classification. Indeed, our commission received many pieces of testimony from the public about the unfairness of the Residential A classification although that classification was deliberated, passed, and signed into law last year. We mention these events primarily to raise the issue of whether the City & County can do a better job of publicizing the Council's deliberations on wide-ranging

issues such as the property tax issues we address in this report so that those in the taxpaying public feel less like they have been slighted.

2 Minimum Tax

We recommend changing the minimum tax provision to language stating that operation of the exemptions shall not reduce the tax below $300 for organizations holding Internal Revenue Code section 501(c)(3) status, and below $1,000 for other organizations.

Currently, the real property tax ordinances contain a minimum tax provision that reads:

> *Notwithstanding any provision to the contrary, there shall be levied upon each individual parcel of real property taxable under this chapter a minimum real property tax of $300.00 a year, except for properties exempt under Section 8-10.27 [relating to property used by public utilities and subject to the public service company tax under HRS chapter 239] and except as provided in Section 8-10.28(b)(2) [relating to low-income rental housing projects on Hawaiian home lands].*

ROH §8-11.1(g). We noted that the present language imposes the minimum tax on all parcels regardless of size, so that a parcel the size of a parking stall, which would be taxed at a far smaller amount if this provision did not exist, would be taxed at $300. We considered that the probable intent of this provision was to require properties owned by exempt organizations to pay some minimal amount of real property tax, and not to penalize small parcels. Thus, we recommend rewording the exemption to say that the operation of any real property tax exemption shall not operate to reduce the tax below a certain amount. That or similar language would not have the effect of increasing the tax that would be due on very small parcels.

There are numerous exemptions allowed in the real property tax ordinances. One of the primary justifications for allowing an organization a real property tax exemption, or a tax exemption in general, is that the organization performs essential work or services that the government would have to perform itself if the organization were not present. Many organizations may claim that they fit that criterion, and the City might not have the expertise or resources to verify such a claim independently. For that reason we recommend more favorable treatment for organizations that are described in section 501(c)(3) of the Internal Revenue Code.

Although 501(c)(3) status is complex to describe, we thought that most Americans are familiar with it. We felt that an organization so described makes certain commitments, such as it must have a clause in its organizing documents permanently dedicating its assets to be given to the government or other similarly described organizations if it is ever to liquidate; it must have a governing body composed of diverse community leaders as opposed to one or two, or a few related people; and it must make key financial information, including most of its tax return, widely available to the public for scrutiny. Charitable organizations are motivated to seek 501(c)(3) status because it usually results in individual donors being allowed a tax deduction for their donations, thereby creating an incentive to donate; such organizations are allowed special mailing privileges among other governmental benefits; and of course the organization itself is exempted from income tax on activities contributing importantly to its mission. The Internal Revenue Service grants such organizations qualification letters, and maintains an online database of such organizations so interested parties can easily and quickly verify the organizations' status.

In contrast, ROH §8-10.10, which is relied upon by most charities and similar tax-exempt organizations, exempts from Honolulu real property tax not only 501(c)(3) organizations, but also cemeteries, labor unions, and any association of league of federal credit unions. The latter organizations, described in Internal Revenue Code sections 501(c)(5), (6), and (9), are tax exempt under Federal income tax law but no charitable deduction is allowed to individuals for contributions to such organizations.

For these reasons, our recommendation is to reword the present minimum tax provision, ROH §8-11.1(g), to read substantially as follows:

> *No provision in this Chapter 8 providing an exemption from real property tax may reduce the tax assessed to any individual parcel of real property taxable under this chapter below $1,000 a year, except: (1) the exemption in section 8-10.10 for charitable use may reduce the tax on a parcel to no less than $300 a year where the property is owned and used by an organization described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended; (2) the exemption in section 8-10.27 (relating to property used by public utilities and subject to the public service company tax under HRS chapter 239) may reduce the tax to zero; and (3) this subsection shall apply only as provided in section 8-10.28(b)(2) (relating to low-income rental housing projects on Hawaiian home lands) for property to which section 8-10.28 applies.*

3 EXEMPTIONS

3.1 HISTORIC RESIDENTIAL HOMES

We recommend changing the exemption to 50% of the assessed value of the property, provided that existing historic residential dedication contracts shall be honored until they are cancelable.

ROH section 8-10.22 permits historic residential real property dedicated for preservation to enjoy a full exemption from real property tax. For fiscal year 2014-2015, 266 parcels of property with an aggregate valuation of $363.2 million had registered for this exemption.

To be dedicated for preservation, the ordinance and its implementing regulations (Chapter 32, Historic Residential Property Dedication Rules) provide:

1. The property owners are to provide visual access at all times from the public way such as a road, alley, street, trail, or other public area; and the public must be able to view the property not more than 50 feet from the property line;

2. If visual access is not available, the owner must provide *alternative visual visitations* (an alternative view) from a viewing point on the historic property for at least 12 days a year on the second Saturday of each month from 9:00 a.m. to 4:00 p.m. The alternative visual visitation must be clearly identified by a sign on the property that marks the location of the viewing point, and the point beyond which the public may not enter;

3. The property must be maintained at least in average condition; and

4. The property must be currently listed in the State of Hawaii Register of Historic Places.

The Commission, after reviewing these requirements, was of the opinion that the owners of such properties are still able to use their property as a home and they are receiving City & County services such as rubbish pickup and police and fire protection, and that the impact of the historical dedication requirements on their use and enjoyment of their home do not justify a full exemption.

The Commission also notes that the Office of the City Auditor, in its Audit of the Real Property Assessment Division, Report No. 13-02 (October 2013), found "many violations of and non-compliance with historical residential property dedication requirements," and estimated that the City could increase tax

revenues by over $555,000 if the Division were to monitor and enforce historic property dedication requirements and cancel the historic property exemptions for noncompliant property owners. The Commission finds regrettable the apparent abuse of this exemption.

At the same time, the Commission understands that the dedication agreements previously entered into between the City & County and the property owners are contracts and need to be respected as such. Although the terms of the ordinance state that the contracts auto-renew, they are cancelable upon five years' notice any time after the first five years. They are also cancelable at any time if the City determines that the property owner is not complying with the terms of the dedication. Thus, the changes in the exemption that this Commission is recommending could not go into effect for everyone at once, but could be implemented if the City were able to cancel the dedication (either for cause or by lapse of time).

3.2 For-Profit Child Care Centers

We recommend repealing this exemption because we believe for-profit entities should be treated alike.

ROH section 8-10.33 allows for-profit group child care centers a full exemption from real property tax. For fiscal year 2014-2015, 7 parcels of property with an aggregate valuation of $12.5 million had registered for this exemption.

Although the owners of such properties may be able to contend that the businesses they are running provide essential services that otherwise would have to be provided by the City, the Commission notes that many for-profit businesses now subject to tax could make the same argument. The existing exemption for charitable uses of property, in section 8-10.10, is based on the same argument, and it, like many other exemptions given to charitable and nonprofit entities, contains a requirement that there be *no private inurement*, namely that no one makes a profit from the activities of the organization. The for-profit group child care center exemption expressly allows for-profit entities to qualify for the exemption, thereby allowing the subsidy provided by this exemption to increase the profits that their owners would reap. Such an exemption also unbalances the playing field of competition and forces the rest of us who are not favored with such an exemption to pay for the City services consumed by these businesses. The Commission accordingly recommends repeal of this exemption.

A child care center that qualifies as a charitable organization would, of course, be exempt if its use of the property qualifies for exemption under section 8-10.10.

3.3 CREDIT UNIONS

We recommend repealing the exemption because, even after having reviewed the testimony of the credit unions to the prior Commission, we find it impossible to distinguish credit unions from taxable organizations in a principled way.

ROH section 8-10.24 allows for-federally chartered or state chartered credit unions a full exemption from real property tax. For fiscal year 2014-2015, 89 parcels of property with an aggregate valuation of $159.8 million had registered for this exemption.

Federal law, 12 U.S.C. §1768, provides that federally chartered credit unions are exempt from all taxation imposed by any state, territorial, or local taxing authority, except that any real property (and tangible personal property) shall be subject to federal, state, territorial, and local taxation to the same extent as other similar property is taxed.

State law, HRS §412:10-122, provides that state chartered credit unions shall have the same immunity from state and local taxation that federally chartered credit unions have. That statute also specifies that any real property of a credit union shall be subject to taxation to the same extent as other similar property is taxed.

Thus, neither federal nor state law preempts county taxation of real property owned by a credit union.

The previous Commission received numerous communications from various credit unions imploring the Commission not to repeal this exemption, citing the fact that these organizations provide financial services to their memberships which normally cannot be accessed at traditional financial institutions. Others stated that as a result of being granted the exemption, they are able to enhance the earnings on their members' deposits and reduce the cost of loans made to their members.

Like the previous Commission, this Commission finds the offered policy rationale deficient. Credit unions are business organizations just like the for-profit child care centers discussed above. There are no prohibitions on private inurement. Credit unions advertise for business and compete for business with other financial institutions. Credit unions may be member-owned and lower costs incurred by the credit union result in cost savings or earnings enhancements to their members; however, many other for-profit businesses give back to the community, and pass on cost savings to their customers through either lower costs of goods or services, or enhanced earnings by way of dividends or distributions. The Commission has found no principled way to distinguish credit unions from other for-profit businesses and, for many of the

same reasons set forth in the section immediately preceding on child care centers, recommends that the exemption that credit unions now enjoy be repealed.

3.4 Hawaiian Homestead Land Exemptions

We recommend phasing these exemption out over a number of years. The properties and people in them are fundamentally the same as other residential properties and their occupants, so we find it difficult to exempt one class and tax the other.

ROH section 8-10.23 provides that real property leased under homestead and not under general lease pursuant to the authority granted the Department of Hawaiian Home Lands by Section 207 of the Hawaiian Homes Commission Act, 1920, shall be exempt from real property taxes, the seven-year limitation on the exemption afforded by Section 208 of the Hawaiian Homes Commission Act, 1920, notwithstanding. For fiscal year 2014-2015, 3,150 parcels of property with an aggregate valuation of $1.406 billion had registered for this exemption.

To understand this ordinance, some background is necessary. Some years after the overthrow of the Hawaiian monarchy, the federal government enacted the Hawaiian Homes Commission Act, 1920 (HHCA), Act of July 9, 1921, ch. 42, 42 Stat. 108. That Act granted certain benefits for native Hawaiians, and set aside certain lands to be managed in trust for the benefit of native Hawaiians. Section 207 of the HHCA granted the enforcing agency, now DHHL, the authority to lease lands to native Hawaiians. Section 208(8) of the HHCA specified that an original lessee "shall be exempt from all taxes for the first seven years after commencement of the term of the lease."

When Hawaii was admitted as a State, the HHCA program was turned over to the State, and the HHCA itself lost its federal nature and became part of the Hawaii Constitution. Hawaii Admission Act, Act of March 18, 1959, Pub. L. No. 86-3, sec. 5, 73 Stat. 4; Haw. Const. art. XII; *Keaukaha-Panaewa Community Association v. Hawaiian Homes Commission*, 588 F.2d 1216 (9th Cir.1978), *cert. denied*, 444 U.S. 826 (1979); *Kepoo v. Watson*, 87 Haw. 91, 952 P.2d 379 (1998).

Thus, the exemption in section 208(8) of the HHCA is still part of state law and must be respected by the county governments, but ROH §8-10.23 goes further and grants such lands a permanent exemption from real property taxes. The statistics above relating to the number of parcels of property and their aggregate valuation of $1.406 billion *do not* include the seven year exemption in section 208(8) of the HHCA. Those parcels number 592 and have an aggregate valuation of $333.6 million.

ROH section 8-10.32 allows kuleana lands a full exemption from real property tax. This provision of the law provides a complete exemption to Hawaiians who were beneficiaries of the division of lands implemented by the Great Mahele under King Kamehameha III and as authorized by "An Act Confirming Certain Resolutions of the King and Privy Council, Passed on the 21st Day of December, A.D. 1849, Granting to the Common People Allodial Titles for Their Own Lands and House Lots, and Certain Other Privileges," Kingdom of Hawaii Laws 1850, p. 202, as amended by "An Act to Amend An Act Granting to the Common People Allodial Titles for Their Own Lands and House Lots, and Certain Other Privileges," Kingdom of Hawaii Laws 1851, p.98. These lands must have remained in the same family(ies) since that time in residential or agricultural use. For fiscal year 2014-2015, 48 parcels of property with an aggregate valuation of $33.8 million had registered for this exemption.

The Commission notes that the exemptions granted by these ordinances have nothing to do with the benefits provided by the City & County. The parcels affected are residential. People live on those lands. Those lands receive City & County services such as police and fire protection, and trash pickup. If the beneficiaries of these exemptions (presumably, Native Hawaiians) receive these services for free or at greatly reduced cost, other residents who do not qualify for the exemptions need to bear the beneficiaries' share of the costs as well as their own. The Commission did not view the fact that a homeowner can trace his or her blood line to someone who lived on this island centuries ago as a policy justification for a free pass from property taxation. Thus, the Commission recommends repeal of these exemptions, preferably on a phased basis.

4 CLASSIFICATIONS

4.1 RESIDENTIAL CLASS A RATE

We recommend keeping the Residential Class A classification for second homes and investors, but adopt a graduated tax rate, where the assessed value of the classified property up to $1 million would be taxed at $3.50 and assessed value over that threshold taxed at a second rate. The second rate would be pegged at an amount to be revenue neutral or higher. This proposal would resolve the cliff effect under current law and go a long way to achieve more fairness.

The committee has primarily focused on this classification due to fairness concerns about how the increased tax is structured. Currently, there is a $1 million assessed value cliff, wherein the affected properties are taxed at a higher $6.00 rate on the entire assessed value. When this new class was

adopted, affected property owners did not appreciate at the time of the assessments in 2013 to scrutinize and possibly appeal any assessment at or above $1 million. In addition, property owners who were otherwise eligible for homeowner exemptions did not appreciate the importance of qualifying and filing for the exemption on a timely basis to fall outside of this new class. This situation has caused much concern in the community and has prompted Mayor Caldwell to ask the Real Property Assessment Division to examine this issue with the Commission.

The "Cliff" at $1,000,000 causes properties assessed just above to pay $2,500 more than a comparable property assessed just below in the identical use and zoning. The proposed two rate structure will solve this problem and distribute the tax increase to higher value parcels rather than those in the $1 to $1.5 million range. This change will eliminate the need for tax appeals by owners whose properties are near the cliff.

4.2 Residential Class A Definition

We recommend eliminating the phrase "has an assessed value of $1,000,000 or more" from the definition. This will expand the class to all investor and second home parcels except those with homeowner exemptions, three (3) or more units or military housing. It aligns the class with all the parcels in this use and zoning.

Based on summary data provided by the Department of Budget and Fiscal Services (DBFS), we estimate about 150,000 owner-occupant units; and less than 10,000 parcels with 3 or more units, vacant apartment-zoned lots, and military housing. So, the Residential class would include about 160,000 parcels. Residential A under this proposal would include the balance of 100,000 parcels in long-term and short term rentals, as well as second homes and vacant residential lots. 7,000 of these 100,000 or about 7% remain assessed above $1 million and do not have full exemptions. This number is likely to go up in the next tax year. This change in classification will not impact those parcels assessed at or under $1,000,000, assuming no change in the $3.50 rate for the first $1,000,000 of assessed value.

4.3 Commercial Class

We recommend that the Council consider a two-rate graduated tax rate structure for this class of properties as commercial properties have a similar assessed value distribution as residential.

Our research of the real property assessment data included 2,208 commercial parcels in the Honolulu and Waikiki zones (1&2), representing about 40% of the total commercial class. This sample showed that 95% of the parcels in

these zones were assessed at less than $1,500,000 and accounted for only 31% of the total assessed value. So, 5% of the parcels assessed above $1,500,000 accounted for 69% of the assessed value in the tax base. A small increase in the tax rate applied to the higher end properties would allow a lower rate for the remaining 95% and be revenue neutral.

4.4 Transient Use Class

We recommend the Council consider a third residential class based upon short-term or transient rental use. The transient definition proposed would be parcels rented for less than 6 months aligning with the State transient accommodations tax (TAT) under Chapter 237D, HRS. Included in this class would be the 810 units with nonconforming use permits, plus an additional estimated 3,000 to 4,000 units operating without permits some of which may violate zoning if rented for less than 30 days.

The recent study by the Hawaii Tourism Authority indicated that there are over 4,000 units in transient use on Oahu. There are over 3,000 units listed on the Vacation Rentals by Owner (VRBO) website which would confirm this number is probably low. Of these 4,000 or more units, 810 have transient vacation use (TVU) permits allowing non-conforming use (NCU) based upon their use being grandfathered in residential zoning (1986). These units have to apply biannually and pay a $400 fee for each TVU. DBFS appeared to want to create a tax class and presumably tax at a much higher rate these easily identified licensed units. We believe that this would be unfair given the historic inability of the City to enforce zoning with a large number of the 4,000 units operating in violation of residential zoning and renting for less than 30 days. Enforcement of zoning is beyond the scope of the Commission. Enforcement of tax laws, state or county, and zoning regulations should be coordinated between our two levels of government; citizens who scoff at these laws should not be tolerated. So, we recommend expanding the class to include all parcels for which the owners are obligated to pay the TAT. This expanded tax would yield more revenue and not create another fairness or ethical issue. We discuss below certain compliance measures that can assist in raising revenues.

5 Tax Compliance

5.1 Verification of Homeowner Exemption

We recommend using the State's income tax return filings as substantiation for the homeowner exemption.

The DBFS should require proof of homeowner exemption applications by requiring an attestation or copy of the Hawaii Form N-11 resident income tax

return filed when claiming the homeowner exemption. Ongoing, the Department of Taxation can assist in cross-checking and verifying home exemption qualifications by cross-checking against Hawaii resident income tax returns filed by homeowners claiming the exemption. For example, DBFS is currently requiring income tax return filings for its just-concluded compromise procedure for Residential A relief, i.e., ensuring that the homeowner is not reporting the home as rental property.

The Commission notes that the Maui property tax ordinance, Maui County Code §3.48.450(D), now requires a tax clearance or similar substantiation for a home exemption. The Honolulu ordinance, ROH §8-10.4, now provides that the director may demand documentation of "the above or other indicia" to substantiate a home exemption application, which would allow DBFS to ask for tax information administratively. If the Council believes that a change to our existing home exemption ordinance is required, the Council could consider language similar to the current Maui ordinance.

5.2 Verification of Transient Use

We recommend requesting that the Department of Taxation require information on TMKs on TAT returns.

The TAT returns, i.e., TA-1 and TA-2, would be a good resource for DBFS if it could include information on the taxpayer's transient or long-term rentals, and second home use. If these forms were changed to include the Tax Map Keys for each property reported on those returns and an appropriate information sharing agreement could be concluded with the Department of Taxation, it would enhance the ability of DBFS to enforce our present tax classification laws. The Commission notes that transient accommodations tax return information is presently authorized to be disclosed to the county tax officials under HRS §237D-13(a)(10).

5.3 Improve Accuracy and Timeliness of Assessments

We recommend third party resources be included as information used for assessments.

Expand assessment methodology to include input from title companies, realtors, and appraisers. Reassess high valued properties after a sale, as well as comparable properties in the same neighborhood.

5.4 Change Exemptions At Time of Sale

We recommend restarting exemption applications after ownership transfer of property.

Homeowners and other exempt entities would need to apply on the new parcel prior to closing. All prior exemptions will be removed at the time of sale from this property. This will affect the following tax year. Late filings, e.g. after April may require an adjustment in the second payment.

6 Board of Review Transparency

6.1 Utilize Websites and Other Social Media for Board of Review Hearings, Information, and Procedures

We recommend posting on the DBFS web site all appeal hearing agenda notices and decisions of the Board for each appeal. Rules governing the Board's procedures should also be posted on the DBFS web site.

At present, there are several Boards of Review established to hear disputes between tax officials and taxpayers. We understand that DBFS has promulgated procedural rules for the conduct of these appeals, but those rules are difficult to access because they are not currently online. Thus the Commission recommends that they be posted online.

Furthermore, the Commission notes that HRS §232-7, relating to boards of review on state tax matters, now specifies that a taxpayer's identity and pertinent documents in the appeal are public information. ROH §8-12.7, relating to boards of review on real property tax matters, is less clear as to what is public information; however, ROH §8-12.7(f) contemplates publication of a report detailing the Board's work, particularly if it has disagreed with the County on property assessments. To enhance transparency and to align the City's policy further with that of the State, the Commission recommends publication of agenda notices and decisions of the Board.

6.2 Clear Instructions on Deadlines for Filing Appeals

We recommend that DBFS ensure that all publications conform to its legal position that the deadline for appeals to the Board is not extended by weekends and holidays, and to post this legal position on its web site.

The recommendation in this section concerns the "weekend rule" for taxes. If a tax form or return is due on a weekend or holiday, the form is not late if it is filed on the next business day. The State and the counties have all adopted this rule for tax forms. For this County the applicable ordinance is ROH §8-1.16. The question is whether this also applies to appeals.

For most appeals in the judiciary system, the computation of time is governed by Rule 26(a) of the Hawaii Rules of Appellate Procedure, which does adopt the

weekend rule. The Intermediate Court of Appeals, in *Marzec v. City and County of Honolulu,* No. 28287 (Haw. App. Aug. 27, 2008) (summary disposition order) indicated in a footnote (footnote 2) that the weekend rule does apply to real property tax appeals.

The Commission considered a publication by the Tax Foundation of Hawaii asserting that an official City & County brochure titled "Real Property Assessment Appeals" (April 2011) indicated that the weekend rule applies, but also asserting that in an actual case RPAD argued that the weekend rule was inapplicable and persuaded the Board to dismiss an actual appeal for that reason.

At a minimum, the City's brochures must be revised to correctly state the City's position on the issue so taxpayers are not misled into filing their appeals late. The Council also may wish to consider amendment of the appropriate ordinances to ensure that the weekend rule in fact does apply to real property tax appeals, so as to align the City's rule with tax appeals involving other tax types and with appeals generally.

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